Marijuana and Federal Tax Law: In Brief

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As an increasing number of states have permitted the use of marijuana for medical and recreational uses,[1] questions have arisen about the federal income tax consequences for businesses that sell marijuana and their buyers. This report discusses the current federal tax treatment in brief for both the sellers of marijuana and their buyers.

Tax Issues for the Seller

Denial of Business Deductions and Credits

There is no question that income from selling marijuana is taxable to the seller, regardless of whether such sale is legal or not under federal or state law. The Internal Revenue Code (IRC) uses a broad definition of income,[2] and income is taxable whether it comes from legal or illegal activities.[3] Furthermore, it may be taxed even if the proceeds are forfeited to the government.[4]

While such income is taxable, the seller will be limited in its ability to deduct business expenses and claim tax credits. Section 280E of the Internal Revenue Code (IRC) provides the following:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.[5]

Marijuana is listed on Schedule 1 of the Controlled Substances Act (CSA).[6] As such, a significant impact of this provision is that, while a taxpayer can generally deduct all "ordinary and necessary" business expenses,[7] marijuana sellers may not deduct their business expenses, even when the expenses themselves are not illegal (e.g., rent). Notably, Section 280E does not apply to the cost of goods sold (COGS), as discussed below.

It is sometimes argued that Section 280E should not apply when the sale of marijuana is authorized under state law, but the U.S. Tax Court has rejected this argument in two seminal cases: *CHAMP v. Commissioner* in 2007 and *Olive v. Commissioner* in 2012.[8] Both cases dealt with medical marijuana dispensaries authorized under California law. Reasoning that the trigger for Section 280E's application is the violation of federal *or* state law, the court concluded that the provision applies to medical marijuana retailers since marijuana is listed on Schedule 1 of the CSA and its sale violates federal law. Further, the court interpreted the term "trafficking" in Section 280E by using its dictionary definition, which is "to engage in commercial activity: buy

[1] For more information, see CRS Report R43435, *Marijuana: Medical and Retail—Selected Legal Issues*, by Todd Garvey, Charles Doyle, and David H. Carpenter; CRS Report R43164, *State Marijuana Legalization Initiatives: Implications for Federal Law Enforcement*, by Lisa N. Sacco and Kristin Finklea.

[2] IRC §61 (gross income is "all income from whatever source derived....").

[3] *See* James v. United States, 366 U.S. 213, 218 (1961).

[4] Wood v. United States, 863 F.2d 417 (5th Cir. 1989).

[5] Section 280E was enacted in 1982 (P.L. 97-248) in response to a 1981 Tax Court decision, *Jeffrey Edmondson v. Comm'r*, T.C. Memo. 1981-623 (1981), allowing an illegal drug business to deduct its business expenses.

[6] 21 U.S.C. §812(c), Sch.I(c)(10).

[7] IRC §162(a).

[8] Californians Helping to Alleviate Med. Problems (CHAMP), Inc. v. Comm'r, 128 T.C. 173 (T.C. 2007); Olive v. Comm'r, 139 T.C. 19, (T.C. 2012).

and sell regularly."[9] This led the court to determine that the term (and by extension, Section 280E's application) is not limited to illegal drug smuggling activities, but also includes sales conducted by a "legitimate operation" authorized by state law, as well as supplying medical marijuana to a clinic's members who pay for it and other services through a membership fee.[10]

In April 2015, two California companies that own medical marijuana dispensaries filed suits in the Tax Court, arguing among other things that a 2014 federal appropriations law affects the Section 280E analysis.[11] Section 538 of the Consolidated and Further Continuing Appropriations Act, 2015 (P.L. 113-235) provides that,

> None of the funds made available in this Act to the Department of Justice may be used, with respect to the States of Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, and Wisconsin, to prevent such States from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.

The companies argue that since Section 538 precludes the Department of Justice from expending funds to prevent a state from implementing its own medical marijuana laws, it necessarily follows that the use, distribution, possession, or cultivation of medical marijuana in conformity with state law is no longer prohibited. As such, they argue that since their businesses operate pursuant to California's medical marijuana laws, Section 280E does not apply. The court has not yet reached a decision in these cases.

Cost of Goods Sold

Section 280E does not apply to the cost of goods sold (COGS).[12] Thus, marijuana retailers may subtract COGS when determining their gross income. COGS are those "expenditures necessary to acquire, construct or extract a physical product which is to be sold."[13] It is basically computed by taking the inventories at the beginning of the year plus the year's purchases (if a seller) or production costs (if a producer) and subtracting the year-end inventories.[14]

The reason COGS falls outside the scope of Section 280E is because COGS is not considered to be a deduction for federal tax law purposes. This conclusion is based on the principle that

[9] *CHAMP*, 128 T.C. at 182.

[10] *See Olive*, 139 T.C. at 38.

[11] Petition for Redetermination, Organic Cannabis Found, LLC v. Comm'r, No. 10593-15 (T.C. April 23, 2015); Petition for Redetermination, Northern Cal. Small Business Assistants v. Comm'r, No. 10594-15 (T.C. April 23, 2015).

[12] See *CHAMP*, 128 T.C. at 178 n.4; *Olive*, 139 T.C. at 20 n.2; Peyton v. Comm'r, T.C. Memo 2003-146, *15 (T.C. 2003); Franklin v. Comm'r, T.C. Memo. 1993-184, *28 n.3 (T.C. 1993); IRS Chief Counsel Advice (CCA) 201504011 (Dec. 10, 2014). CCAs may not be used or cited as precedent. IRC §6110(k)(3).

[13] Reading v. Comm'r, 70 T.C. 730, 733 (T.C. 1978).

[14] *See also* IRS CCA 201504011 (indicating that marijuana retailers will generally be required to use the accrual (and inventory) method of accounting and providing relief for cash basis taxpayers who cannot be required to use the accrual method, as well as stating that taxpayers subject to Section 280E must use the costs as provided under Section 471 when Section 280E was adopted, rather than the uniform capitalization rules in Section 263). For information on accounting methods, see CRS Report R43811, Cash Versus Accrual Basis of Accounting: An Introduction, by Raj Gnanarajah.

"income" for purposes of the U.S. Constitution[15] and the IRC[16] refers to gross income and not gross receipts (i.e., "income" does not include the return of capital).[17] This principle is reflected in Section 280E's legislative history, with the relevant Senate Report stating that "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."[18]

Other Parts of the Business

Section 280E only applies to the drug part of a business. Thus, for example, the Tax Court has determined that a clinic that provided a variety of services to terminally ill patients and supplied marijuana to some patients as part of that care could deduct the expenses related to the other care and services provided.[19] However, when the provision of support and other services was merely incidental to the dispensing of marijuana, then the Tax Court has held that the business is not able to deduct any expenses.[20] The test the Tax Court has used for determining whether the marijuana part of a business can be separated from the other parts is whether they "share a close and inseparable organizational and economic relationship."[21]

Equal Protection Claims

There are several cases currently before the Tax Court in which the taxpayers are arguing that Section 280E violates the U.S. Constitution's equal protection guarantees.[22] The argument is that Section 280E is unconstitutional because it impermissibly differentiates between drug trafficking and other activities illegal under federal law. The taxpayers appear to have a high hurdle to overcome in order to succeed on this claim. In general, classifications made for federal tax purposes are constitutionally permissible so long as "they bear a rational relation to a legitimate governmental purpose."[23] This is a low standard of review by the courts, and they typically show great deference to tax classifications made by legislatures. As the Supreme Court has noted, "[i]t

[15] *See* U.S. CONST. Amend. XVI (allowing Congress to impose "taxes on income" without apportionment).

[16] *See* IRC §61(a)(3) (starting point for determining a taxpayer's income tax liability is "gross income," which includes "net gains derived from dealings in property"); Treas. Reg. §§1.61-3, 1.61-6.

[17] *See, e.g.*, Stratton's Independence v. Howbert, 231 U.S. 399, 415 (1913) ("Income may be defined as the gain derived from capital, from labor, or from both combined."); Doyle v Mitchell Bros. Co., 247 U.S. 179, 185 (1918) ("Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("The power to tax income like that of the new corporation is plain and extends to the gross income."); Reading v. Comm'r, 70 T.C. at 733 (taxpayer "can have no gain until he recovers the economic investment that he has made directly in the actual item sold").

[18] S.Rept. 97-494, 309 (1982).

[19] *CHAMP*, 128 T.C. at 182.

[20] *See Olive*, 139 T.C. at 41.

[21] *Id.*

[22] Petition for Redetermination, Organic Cannabis Found., LLC v. Comm'r, No. 10593-15 (T.C. April 23, 2015); Petition for Redetermination, Northern Cal. Small Business Assistants v. Comm'r, No. 10594-15 (T.C. April 23, 2015); Canna Care, Inc. v. Comm'r, T.C. Docket No. 005678-12 (petition filed March 2, 2012). The cases filed in April 2015 make additional constitutional claims, including allegations that Section 280E is unconstitutionally vague under the Due Process Clause; an unconstitutional exercise of Congress's Commerce Clause authority because it applies to the intrastate manufacture and sale of medical marijuana; raises federalism concerns because of its interaction with California law; is an excessive fine under the Eighth Amendment; and represents an unconstitutional exercise of Congress's taxing power because it is a penalty and not a tax. The court has yet to rule on the taxpayers' claims.

[23] Regan v. Taxation with Representation, 461 U.S. 540, 547 (1983).

has … been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification."[24] As such, equal protection challenges to tax legislation almost never succeed. The Tax Court has yet to issue opinions in these cases.

Legislation

In the 114th Congress, the Small Business Tax Equity Act of 2015 (S. 987 and H.R. 1855) would amend Section 280E so that its prohibition would not apply to businesses that sold marijuana so long as the sales were conducted in compliance with state law.

Employment Taxes

Marijuana sellers must comply with federal tax laws regarding the withholding and payment of payroll taxes. One issue that has garnered attention relates to the fact that some marijuana sellers operate in cash due to impediments with opening bank accounts.[25] This causes problems under the federal tax code because it requires that employers pay payroll taxes electronically and subjects them to a monetary penalty for failing to do so.[26] Thus, marijuana sellers who pay payroll taxes in cash may be penalized up to 10% of the taxes paid.[27]

While the penalties can be abated if there is a reasonable cause for the failure to file electronically,[28] the IRS has taken the position in at least some cases that the inability to secure a bank account due to current banking laws does not constitute reasonable cause.[29] At least one business has filed suit challenging the imposition of the penalty when it was unable to comply with federal tax law because it could not open a bank account.[30] In March 2015, it was reported that the business and IRS had reached an agreement in which the IRS would abate the penalties in exchange for withdrawal of the lawsuit.[31] It is not clear how this might affect similar cases or the extent to which other businesses may have received abatements.

Tax Issues for the Buyer

Medical Expense Deduction

Under IRC Section 213, taxpayers are allowed to deduct qualifying medical expenses to the extent such expenses exceed 10% of their adjusted gross income.[32] Treasury regulations deny a

[24] *Id.* (quoting *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940)).

[25] For information on banking issues, see CRS Report R43435, *Marijuana: Medical and Retail—Selected Legal Issues*, by Todd Garvey, Charles Doyle, and David H. Carpenter; CRS Legal Sidebar WSLG1205, *The "M" in MBank is Not for "Marijuana"*, by David H. Carpenter; CRS Legal Sidebar WSLG934, *Colorado's Latest Attempt to Grant Marijuana Dispensaries Access to Financial Services*, by David H. Carpenter and M. Maureen Murphy; CRS Legal Sidebar WSLG828, *FINCEN Guidance for Banks Serving Marijuana-Related Businesses*, by M. Maureen Murphy.

[26] IRC §6302.

[27] IRC §6656.

[28] IRC §6656(a).

[29] *See* Tripp Baltz, *IRS Agrees to Drop Penalty Against Unbanked Marijuana Seller for Not Filing Electronically*, BNA DAILY TAX REPORT, March 24, 2015.

[30] Allgreens LLC v. Comm'r, T.C. Docket No. 28012-14L (petition filed Nov. 24, 2014).

[31] *See* Baltz, *supra* note 30.

[32] IRC §213. For taxpayers over the age of 65, the 10% threshold is reduced to 7.5% until 2017. IRC §213(f).

deduction for illegally procured drugs and illegal treatments.[33] The IRS has ruled that marijuana obtained in violation of the CSA is not legally procured and that the amounts spent to obtain it are expended for an illegal treatment, regardless of marijuana's status under state law.[34] As such, amounts spent on marijuana are not deductible as medical expenses, even if the sale and use is authorized under state law.

Tax-Advantaged Health Accounts

Under the IRC, there are several types of tax-advantaged accounts that can be used to pay for unreimbursed qualifying medical expenses: health care flexible spending accounts (FSAs), health reimbursement accounts (HRAs), health savings accounts (HSAs), and medical savings accounts (MSAs).[35] For purposes of these accounts, qualifying unreimbursed medical expenses are defined with reference to Section 213(d).[36] Medical marijuana is not a deductible medical expense under Section 213. Therefore, it is not an eligible expense for purposes of these accounts and taxpayers may not use funds in these accounts to pay for medical marijuana.

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[33] *See* Treas. Reg. §1.213-1(e)(1)(ii) and (2).

[34] *See* Rev. Rul. 97-9, 1997-1 C.B. 77.

[35] For information on these types of accounts, see RS21573, *Tax-Advantaged Accounts for Health Care Expenses: Side-by-Side Comparison, 2013*, by Carol Rapaport.

[36] IRC §§105(b), 220(d)(2), 223(d)(2).